

D. Limiting the Frequency of Cost-Based Showings for a Given Tier to Once a Year is Reasonable

The Commission's proposal (Notice at ¶ 17) to limit cost based showings for any particular tier to once a year is a reasonable compromise between operator interests and administrative exigencies. However operators should be able, where warranted, to recoup any significant costs incurred during the period when they were foreclosed from making such showings. In addition, the Commission and local regulators should be willing to waive this one year limitation where circumstances warrant such a waiver.

E. The Commission Should Not Issue a Form for Cost Showings

The Notice (at ¶ 19) proposes that the Commission issue a form on which cost-of-service presentations would be made. This proposal seems to be based on the assumption that cost-based price justifications will all follow a common pattern, based on the public utility rate-of-return model.

As noted elsewhere in these comments, the Commission cannot and should not restrict or limit cost-based presentations to any particular means or method, and should take special steps to avoid channelling such presentations into the traditional public utility framework.

Given its current level of knowledge of the cable industry and its total lack of experience with cable price regulation, the Commission is in no position to define and prescribe forms for cost-based price presentations. It is likely to be impossible to

prescribe a form adequate for a full cost-of-service showing, and it is simply too early to know what information and method of presentation will best suit the more narrow cost-based showings that need to be allowed. Perhaps, after a period of experience, the Commission will be in a position to prescribe forms for the calculation of particular add-ons or high-cost factors, but it cannot be done now.

V. THE COMMISSION SHOULD ONLY ADOPT GENERAL GUIDELINES FOR COST OF SERVICE SHOWINGS

Although it would be premature for the Commission to prescribe a form for making cost-of-service showings, it might be useful generally to define the elements of the showing that must be made where a cable operator seeks to justify above-benchmark prices on the basis of overall costs. Defining the elements of such a showing in broad terms may give some useful structure to making and reviewing cost-of-service showings. The traditional cost-of-service elements identified in the Notice -- expenses, ratebase, and rate-of-return -- provide a useful framework for that effort, so long as the full baggage of public utility regulation, with all of its attendant burdens and distortions, is not automatically imported into the process along with the terminology.

A. The Commission Should Permit Recovery of All Expenses Associated With the Provision of Regulated Services

The Notice proposes as general principles (i) that a cost-based showing permit the cable operator to recover operating expenses, depreciation, and taxes as annual expenses, and (ii)

that expenses unrelated to the provision of cable service not be includable in such a showing. Notice at ¶ 23. As general principles, these proposals are unobjectionable. The Commission should make clear, however, that all reasonable expenses associated with the provision of regulated cable service, not just those specifically mentioned in Paragraph 24 of the Notice, are to be includable and recoverable. Just by way of illustration, expenses related to regulated service, such as pole attachment fees, employee training, customer service, vehicle expenses, copyright fees, local origination, as well as all salaries and related benefits should clearly be included. Expenses that are unrelated to regulated service should, of course, be excluded.

In response to the inquiry in the Notice (at ¶ 59) regarding allocation of common costs, Time Warner submits that the Commission should allocate common costs in the manner set out in Sections 76.924(f) and (g) of the rules adopted in the Rate Order. Those rules provide for direct assignment of costs where possible, based on the "origin" of the costs, cost-causative linkage with directly assignable costs, and allocation proportionate to the assignment of direct costs. Greater specificity on this issue is neither feasible nor desirable at this time.

1. Cable operators should be permitted to earn a profit or mark-up on their investment in programming

The Notice (at n. 24) recognizes a very important issue regarding expenses incurred in obtaining programming. There, the Commission asks whether programming expenses -- which, in the context of the cable industry, should be viewed more as investments than expenses -- should be treated as a simple expense or whether cable operators should be entitled to a profit or mark-up on those expenses. Time Warner submits that the public interest in program quality is best served by allowing cable operators such a profit or mark-up as an incentive to make investments in programming. By contrast, regulations that contain disincentives to increase program choice and quality -- the very heart of a cable operator's business -- exacerbate the already serious First Amendment problems inherent in the statute and the FCC's regulatory scheme.

Properly understood, the relationship between a cable operator and its programming vendors is quite unlike the ordinary vendor-customer relationship that a cable operator may have with firms that sell it electricity or office supplies. Rather, the relationship has essential risk sharing and revenue sharing characteristics of a joint venture. Risk is shared because the combined and individual revenues of the parties are dependent on the success or failure of their joint efforts (a) to offer popular and attractive programming and (b) to promote and distribute that programming to viewers. Revenues are shared

through subscriber fees and sales of advertising availabilities. The overall success of the cable system and the programmer are interdependent.

The cable operator assumes risk when it contracts for programming. That risk goes beyond the amounts paid or foregone in the particular transaction, because the cable operator's business depends on the often uncertain attractiveness of particular programming. Recognition and reward for this risk will help to ensure that cable operators continue to make socially desirable investments in untried new services, niche programming, and minority-oriented programming.

While the First Amendment prohibits governmental regulation of the quality of cable television programming, the First Amendment and the public interest also prohibit the Commission from impeding or impairing the quality and diversity of that programming through price regulation under the Cable Act. Given the generally recognized positive correlation between cost and quality of television programming,⁹ the Commission should scrupulously avoid creating incentives for cable operators to diminish their investments in programming.

For these reasons, the Commission should permit recovery of the full or true economic cost of programming by allowing a profit or mark-up above the actual amount expended in any given year.

⁹ See note 7, supra.

2. The Commission cannot and should not prescribe depreciation rates for the whole cable industry

The treatment of depreciation rates proposed in the Notice (at ¶ 27) is a prime example of the unfortunate tendency in the Notice to impose industry-wide burdens in order to construct a "backstop" for what the Commission itself assumes will be a small number of systems. The Commission should not impose the burden of such an undertaking on itself or the industry. Rather, the Commission should adopt a general policy of accepting, for cost-of-service purposes, the rates and practices actually used by a particular system in its financial statements, which the Commission has already required to be consistent with Generally Accepted Accounting Principles (GAAP).¹⁰ At the same time, the Commission should gather information about industry practices that will enable it with greater confidence to determine whether a given operator's practices are reasonable. There is no need ever to impose any rates or practices on those systems that do not elect to base their prices on a full cost-of-service showing.

The Commission's own experiences with efforts to establish and modify depreciation rates illustrates graphically why such efforts would be unacceptable here. Over the course of more than fifty years, the FCC has developed a set of complex and time-consuming procedures for setting revised depreciation rates for

¹⁰ Depreciation expense should generally comprise depreciation taken against the entire depreciable capital invested in the system, regardless of the valuation of the "ratebase."

just the major telephone companies. See, e.g., Represcription Order, 6 F.C.C. Rcd. 750 (1991). Even though the history and extensive physical and technical integration of those companies make them dramatically more homogeneous than the cable industry, the Commission still finds it necessary to set depreciation rates company-by-company. Despite its years of experience, the Commission still devotes many months to this effort for each company every three years.

In the case of the cable industry, the Commission has no relevant experience or regulatory history to guide it. There are many more cable operators than there are major telephone companies, the operations of those cable companies differ widely in matters such as type and vintage of plant, and the Commission has no expertise in these matters. There is simply no way for the Commission to undertake a depreciation rates prescription for each company in the cable industry, and it would be neither permissible nor practical to impose a single schedule on the whole industry. The requirement for GAAP accounting will provide all the consistency that is required for these purposes.

3. Taxes should be a recoverable expense regardless of the form of ownership of the system

The Notice (at ¶ 30) properly proposes to treat taxes as an includable expense. However, it then proposes (at n. 32) to exclude taxes where the cable system is owned by a Subchapter S corporation. No reason for this exclusion is stated.

As a general legal matter, regulated entities organized as partnerships or Subchapter S corporations are permitted to recover an imputed item for taxes as if they were corporations. See, e.g., Greely Gas Co. v. State Corp. Comm'n., 807 P.2d 167 (Kan. App. 1991); Suburban Utility Corp. v. Public Utilities Comm'n., 652 S.W.2d 358 (Tex. 1983).

This issue is significant, because partnership and Subchapter S ownership structures are relatively common in the cable industry. The owners of those systems pay taxes on income they derive from cable systems just as corporations do; this expense should be recovered as one related to regulated services. The Commission should not impose the exclusion proposed in the Notice.

B. The Commission Should Presumptively Allow a Return on All of the Capital Shown to Have Been Invested in the System

The Notice raises a series of questions under the general heading of defining a "ratebase." Notice at ¶¶ 31-45. Essentially, the Commission proposes to promulgate several a priori rules to define the capital investment on which a return is to be allowed. Time Warner submits that this is an area in which the heterogeneity of the cable industry and the overall lack of experience with cost-of-service regulation of the modern cable industry make any effort to promulgate general rules unwise and improper.

As a general matter, the Commission should allow a return on all capital invested in assets associated with the provision of

regulated cable service. Questions as to the usefulness of a particular asset (the "used and useful" issue of traditional utility regulation) and questions regarding the prudence of a particular capital investment may well arise. However, the Commission and local regulators should resist wherever possible the temptation to micromanage and second-guess the cable operator, particularly as to investments made prior to regulation. Such resistance is necessary to minimize some of the well-recognized adverse consequences of traditional public utility regulation.

1. The Commission cannot and should not promulgate a general rule excluding "excess acquisition costs"

The Notice states an intention to promulgate a general rule excluding out-of-hand the costs incurred by an operator in acquiring a system in excess of the "original cost" of the assets acquired. This proposal rests on an assumption that Time Warner believes is false: that cable operators are monopolists. Such a finding is not compelled by the 1992 Act. Thus, the Commission may not base the disallowance of previous acquisition costs on that incorrect premise. Even if cable operators were monopolists, however, Time Warner believes any disallowance of costs that were lawful when incurred would be unconstitutional. Further, this proposal assumes both that it is feasible to calculate the original costs and that amounts in excess of such costs must necessarily be "imprudent" or otherwise not of value to regulated operations. Both of these assumptions are unjustified. Here, as elsewhere, the Commission must refrain

from shooting in the dark and, instead, await concrete cases in which such costs can be identified and evaluated in the context of a particular system.

As a theoretical matter, valuation of a cable system's capital assets on an original cost basis would not provide an accurate or fair assessment of the value of those assets. For example, original cost valuation ignores the effects of inflation. Use of an original cost valuation would, therefore, expropriate cable companies' investments in the amount of any accumulated inflation.

As a practical matter, the original cost of a cable system's assets may not be ascertainable at all. Unlike the utilities to which original cost ratemaking has long been applied, cable operators have had no business reason to keep detailed records of such costs. Book values of acquired systems are typically determined on the basis of an appraisal by an engineering consulting firm. The appraisal attempts to value the assets as they then exist, taking into account any relevant attributes of the plant then in existence. The difference between the purchase price and the appraised value of the physical (tangible) assets is then assigned to various intangibles.

Even where some measure of original cost is available, there is no basis whatsoever for a binding conclusion that acquisition costs in excess of that amount represent expected monopoly rents, even assuming arguendo that cable operators are monopolists. Indeed, the Notice itself recognizes (at ¶ 38 and n. 40) that not

all of the "excess acquisition costs" were necessarily incurred in the expectation of monopoly rents, and that cable companies have had numerous valid and publicly beneficial reasons for making acquisitions.

For example, the common practice of "clustering," where cable operators seek to acquire neighboring systems in order to achieve operating efficiencies, may give rise to an acquisition price that reflects these expected efficiencies. That price may well include what the Notice calls "excess acquisition costs" (Notice at ¶ 36). Nonetheless, there is no conceivable good reason to deny the operator a return on an efficiency-enhancing investment.

The Commission recently recognized the efficiencies inherent in the regional clustering of cable systems by tentatively rejecting the adoption of regional horizontal cable ownership limits:

We are also concerned that the imposition of regional limits may sacrifice many of the benefits and marketplace efficiencies associated with regional concentration, such as investment in the deployment of fiber optic cable, development of local and regional cable programming, and improved customer service.¹¹

For example, Time Warner's Rochester division made an acquisition in the mid-1980s that "filled out" the cluster of systems operated by Time Warner in that area. Since then, the

¹¹ Implementation of Sections 11 and 13 of the Cable Television Consumer Protection and Competition Act of 1992, Horizontal and Vertical Ownership Limits, Cross-Ownership Limitations and Anti-Trafficking Provisions, MM Docket No. 92-264, FCC 93-332 (released July 23, 1993) ("Ownership Further Notice") at ¶ 137.

Rochester operation has been able to reduce the combined overhead, use its technical expertise to offer more channels and better signal quality to its customers, and create a local news channel targeted to the Rochester community. The economies of scope and scale created by clustering through acquisition have thus enabled Time Warner to enhance service to subscribers. Indeed, Time Warner's excepted transformation of its Orlando, Florida, cable system into "Full Service Networks" by providing a wide array of switched digital services,¹² has been facilitated in large part by the benefits and efficiencies of clustering. The Commission has recognized this important benefit of clustering, as well:

Moreover, we are cognizant that denying cable operators the benefits of regional concentration could impede their ability to become competitors of local telephone companies.¹³

Sound public policy certainly would not diminish or destroy the incentives to engage in such publicly beneficial transactions.¹⁴

Whether these or other reasons that the Commission would recognize as proper justifications for a particular acquisition price are present can only be determined by case-by-case analysis

¹² See "Time Warner Plans Electronic Highway," Multichannel News, February 1, 1993, at 1.

¹³ Ownership Further Notice at ¶ 137.

¹⁴ H.R. Rep. No. 102-628, 102d Cong., 2d Sess. 43 (1992); S. Rep. No. 102-92, 102d Cong., 1st Sess. 33 (1991); Implementation of Sections 11 and 13 of the Cable Television Consumer Protection and Competition Act of 1992, Horizontal and Vertical Ownership Limits, Cross-Ownership Limitations and Anti-trafficking Provisions, MM Docket No. 92-264, FCC 92-542 (released December 28, 1992).

of system costs in the course of particular cost-of-service showings. Significantly, the Commission has followed just such a case-by-case approach to efforts by telephone companies to include such costs in their ratebases:

[W]e continue to believe that inclusion of such amounts must be determined on a case-by-case basis and require the acquiring carrier to demonstrate that the price paid for the property accurately reflects its value to the ratepayers or is otherwise in the public interest.

Rate Base Reconsideration Order, 4 FCC Rcd 1697, 1704 (1989), aff'd sub nom. Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993). Even in the case of ordinary plant acquisitions by telephone companies, the Commission concluded that "the nature of the acquisitions and the circumstances under which they take place are highly diverse and specific criteria cannot be developed for all situations." Rate Base Reconsideration Order, 4 FCC Rcd at 1705.

If the Commission can retroactively disallow some acquisition costs, given the diversity and heterogeneity of the cable industry, it still would not be fair or lawful for the Commission to determine in advance that all amounts above original costs of assets should be disallowed. Case-by-case consideration of this issue would be the only fair and lawful way to proceed.

2. Accumulated losses should be included in the capital on which a return is allowed

The cable industry is still a relatively new industry, and many of the companies in the industry are in or near start-up or high-growth phases. Such companies typically

incur expenses in excess of revenues and expect to recover them in later years. As recommended in the accompanying NERA paper at Section III(D), these investments in the cable system should be treated as any other capital investment: They should be included in the capital on which a return is allowed in a full cost-of-service proceeding.

C. The Commission Should Ensure that Returns on Capital in Cost of Service Proceedings are Sufficient to Reflect the Relative Riskiness of Cable Investments and the Particular Requirements of Individual Systems

In the Notice (at ¶ 52), the Commission tentatively proposes -- apparently for reasons of perceived administrative efficiency -- to adopt a uniform, industry-wide rate of return to set the cost of capital in all cable cost-of-service proceedings. Here, once again, the Commission leans inexplicably toward an industry-wide approach to a question that the Commission has already determined applies only to a particular, atypical segment of the industry. Once again, Time Warner urges the Commission to take a case-by-case approach to case-by-case problems.

The Commission's inclination toward prescription of a unitary rate of return for the cable industry is apparently based on the Commission's experience with doing so for the telephone industry. There are, however, enormous differences between the cable industry and the telephone industry. Two differences of particular relevance here are (1) the wide differences among companies within the cable industry in financial structure and business practices, and (2) the dramatic differences between the cable industry and the telephone industry.

Cable companies differ widely from one another in terms of financial structures, debt/equity ratios, and overall financial strength. They experience widely differing subscriber densities, penetration rates, churn rates, and collection levels, all of which -- together with numerous other factors -- cause the overall riskiness of cable companies to differ widely. Some systems are financed at a relatively local level while others obtain financing through corporate-wide capital sources of major companies.

When the Commission decided to adopt unitary rates of return for the telephone industry, it did so precisely because it concluded that the homogeneity of the telephone industry permitted such treatment. The Commission concluded, for example, that the former Bell System companies were intentionally set up at divestiture to have similar capital structures, credit ratings, regulatory environments, and management cultures, and that the risks faced by those companies are all very similar. See Supplemental Notice of Proposed Rulemaking, CC Docket 84-800, FCC 85-458, 50 Fed. Reg. 33786, 33790 (21 Aug. 1985). The Commission also noted that the major telephone companies generally provide one homogeneous service to be regulated at the federal level: interstate switched access. Id., 50 Fed. Reg. at 33789.

The Commission proposes (Notice at ¶ 50) to use the S&P 400 as a surrogate for cable industry capital costs, apparently because it has used the S&P 400 on a previous occasion in

connection with evaluating rate of return issues for the telephone industry. However, the S&P 400 was used in the telephone context only as a point of comparison with other measures of cost of equity, including, primarily, the individual companies' own DCF analyses. See Phase II, FCC 85-645, 59 Radio Reg. 2d (P&F) 651 (1986).

The Notice does not explain why or how the S&P 400 can serve as a valid surrogate for the cable industry's "average" cost of capital. More importantly, however, even if the Commission were able to calculate an "average" cost of capital for cable companies, that conclusion would be irrelevant, by definition, to the unusual, high-cost cable systems for which the cost-of-service backstop is to be available. To determine whether the prices of such companies are reasonable, the Commission needs to know the cost of capital actually faced by each such company, not an industry average.

Other regulatory agencies have experienced just how difficult -- if not impossible -- it is to prescribe industry-wide, unitary costs of capital. For example, the Federal Energy Regulatory Commission (FERC) set out in 1982 to promulgate industry-wide rates of return for the electric power industry. Over the course of ten years, the FERC went from an effort to promulgate mandatory rates of return,¹⁵ through an effort to establish "advisory" rates of return for the industry, to

¹⁵ Generic Determination of Rate of Return on Common Equity for Electric Utilities, 47 Fed. Reg. 38332 (31 Aug. 1982).

ultimate abandonment of industry-wide rate of return efforts altogether.¹⁶ This experience -- again in a long-regulated, relatively static public utility industry -- illustrates the implausibility of promulgating a unitary cost of capital for the vastly more heterogeneous cable industry. Case-by-case efforts are the only answer.

These same considerations apply to calculating the cost of debt. The Commission should permit recovery of the actual cost incurred by the company, on a case-by-case basis. There is no need for general industry standards rules, or presumptions, and it is nearly certain that any such generalizations would be unduly imprecise and unfair.

VI. THE COMMISSION NEED NOT AND SHOULD NOT MANDATE UNIFORM ACCOUNTING RULES OR PRACTICES FOR THE CABLE INDUSTRY

A. The Commission Cannot and Should Not Promulgate a Uniform System of Accounts for Cable Systems

Despite legislative history of the 1992 Cable Act that specifically rules out the prescription of a uniform system of accounts for the cable industry,¹⁷ the Notice (at ¶ 58) inquires whether the Commission should promulgate a uniform system of accounts for the cable industry. Time Warner strongly opposes

¹⁶ Generic Determination of Rate of Return on Common Equity for Electric Utilities, 57 Fed. Reg. 802 (9 Jan. 1992)

¹⁷ "It is not the Committee's intention to replicate Title II regulation. The FCC should create a formula that is uncomplicated to implement, administer, and enforce, and should avoid creating a cable equivalent of a common carrier 'cost allocation manual.'" H.R. Rep. No. 102-628, 102d Cong., 2d Sess. 83, quoted in Notice at n.16.

the adoption of uniform accounting requirements beyond the GAAP requirement already adopted in the Rate Order. The imposition of regulatory accounting requirements is a costly and intrusive step for which there is absolutely no need. While some standardization of the presentation of financial data by individual cable systems might turn out to be necessary in those instances (expected to be few in number) in which those systems choose to justify their prices based on all of their costs, that is no reason to require the rest of the industry to shoulder the burden of changing accounting practices and keeping "regulatory books." For those companies whose prices are regulated by the benchmarks, such books and accounts are totally unnecessary to the companies and their regulators.

Here again, the temporary nature and limited scope of the "backstop" options for cable price regulation must be kept in mind. Congress did not direct that the Commission establish a permanent, public-utility-style regulatory regime; it directed exactly the opposite, and singled out uniform systems of accounts as exactly the kind of thing that should not be imposed on the industry.

The argument advanced in the Notice (at n. 16), that it is permissible to impose upon the entire industry, through the secondary, "backstop," regulatory mechanism, burdens and requirements that may not be imposed through the primary (benchmark) mechanism, is wholly illogical. It certainly makes no sense to have a "backstop" that is more invasive and

burdensome to the entire industry than the primary means of regulation to which the majority of industry prices are likely to be subject. The only permissible reading of the pertinent legislative history is that artifacts of public utility regulation, such as a uniform system of accounts, simply may not be imposed on the cable industry.

The pace and duration of the Commission's decade-long efforts to revise the uniform system of accounts (USOA) for telephone companies illustrate graphically the difficulty of promulgating accounting rules for the cable industry. In the case of the telephone industry -- an industry with which the Commission had many years of experience and a staff of industry experts -- it still took from 1978 until 1987 to complete a revision to the USOA, and that revision was itself possible only because the Commission had the knowledge and resources needed to devise a computerized system for reporting and maintenance of USOA data. See Revision of the Uniform System of Accounts, 60 Rad. Reg. 2d (P&F) 1111 (1987); Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies, 3 F.C.C. Rcd. 6375 (1988).

Thus, even if it were permissible for the Commission to promulgate a uniform system of accounts for the cable industry, it would be unwise for the Commission to undertake to do so. At this time, the Commission simply does not have sufficient experience with cable price regulation to know what costs are

relevant and how they can most usefully be recorded and presented for regulatory purposes.

B. The Commission Should Not Average Costs on an MSO-Wide Basis

The Notice (at ¶¶ 60-63) inquires regarding the desirability of averaging MSO costs to generate a "company-wide (MSO) per-subscriber ratebase, operating expenses and depreciation". *Id.* at ¶ 60. This presents yet another instance where the Notice proposes averaging, in the interest of administrative convenience, that would undermine the very purpose of the "backstop" level of price regulation with which the Notice is concerned. Such averaging would render it impossible to discern the particular non-average circumstances giving rise to the need for a particular system to resort to a cost-based justification for its prices. Also, requiring MSO-company averaging would result in "low-cost" subscribers subsidizing "high-cost" subscribers. Given that the issues in cost-based pricing efforts will be franchise-specific, the data relied on in such efforts must also be as close to franchise-specific as possible.

C. The Commission Should Adopt Affiliate Transaction Rules and Eliminate the Rate Order Limitation on Pass-Throughs of Costs for Programming Services of Affiliated Programmers

The Notice proposes (at ¶ 67-69 and n. 70) a constructive approach to affiliate transactions. Time Warner concurs with the proposal to establish affiliate transaction

rules on the basis of prevailing company prices offered in the marketplace to third parties.

Petitions for reconsideration of the Rate Order have already shown that the limitation imposed in the Rate Order (at ¶ 252) on pass-throughs of programming price increases from affiliated programmers threatens programming quality. Time Warner therefore agrees with the Notice that the adoption of the proposed affiliate transaction rules should be accompanied by revision of the Rate Order limitation on pass-throughs to conform that treatment to the one proposed in the Notice.

VII. THE COMMISSION SHOULD COMMENCE A SEPARATE PROCEEDING TO CONSIDER AND PROMULGATE FEDERAL COST GUIDELINES FOR REGULATED SUBSCRIBER EQUIPMENT

The Rate Order (at ¶¶ 294-298) provides that each franchise authority may regulate virtually all cable subscriber equipment on a cost basis. Numerous petitions for reconsideration of that determination have been filed.

Time Warner, throughout these comments, has consistently opposed the use of nationwide standards or averaging in connection with the backstop regulatory scheme, which is the principal subject of this Notice. Equipment standards relate, however, not only to backstop regulation but to the entire system of cable price regulation adopted by the Commission. In this particular instance, therefore, Time Warner urges the Commission to adopt the proposal (at ¶ 79) to issue federal standards for cost-based equipment regulation as an option available both to cable companies electing to base their service prices on cost

showings and to cable companies whose service prices are regulated by the benchmark method.

Cable subscriber equipment consists almost exclusively of standardized equipment marketed nationally (and even internationally) for use without significant local modifications. Because cable companies' capital costs will, of course, vary, any industry-wide approach to equipment costing should be optional, not mandatory, so that companies whose equipment costs are unusually high due to capital costs (or other factors) have the opportunity to recover those costs.

The Rate Order determination to require individual jurisdictions to develop cost standards and data on their own is likely to prove needlessly costly and inefficient, since it would require replication of the same efforts and generate considerable controversy. Local regulators would face an inevitable incentive to try to shift costs to other jurisdictions, and the Commission would wind up having to resolve the resulting appeals by adopting uniform national standards in any event.

For these reasons, the Commission should commence a separate proceeding to develop and issue subscriber equipment cost standards for optional use by all cable operators, at the local and federal level, whether their service prices are based on costs or benchmarks.

VIII. THE COMMISSION SHOULD NOT ADD A PRODUCTIVITY OFFSET TO THE PRICE CAP FRAMEWORK

The Rate Order established a price cap framework for adjusting the benchmark rates. The formula, which applies to

rates exclusive of programming costs, adjusts the initial benchmark rates by an inflation factor. The Commission asks at paragraphs 81-85 of the Notice whether a "productivity offset" should be added to the price cap adjustment formula. In particular, the Commission asks whether the productivity offsets established for AT&T and Local Exchange Carriers (LECs) should be used for the cable industry.

Time Warner submits that there is no reasonable basis for a productivity offset for the cable industry beyond the one already inherent in the price cap formula adopted in the Rate Order. Moreover, substantial differences between the services, architecture, technology, operations, and especially historical regulatory treatment of telephone and cable companies prevent meaningful comparisons between the two industries.

A. Selecting the "Wrong" Productivity Factor Will Defeat the Goals of Benchmark Regulation by Generating an Excessive Number of Cost-of-Service Showings

Price caps play a critical role within the benchmark regulation framework: They provide a mechanism to adjust rates to reflect inevitable inflation in input costs. Without the price cap mechanism, the benchmarks would quickly become obsolete.

In order to succeed, the price cap adjustment formula must adequately reflect pressures on cable system costs. If input cost pressures are greater for the cable industry than for firms in the economy as a whole, or if realistically attainable productivity increases are lower than the figure set by the formula,

then benchmark regulation will inevitably cease to function as the primary means of cable price regulation.¹⁸

B. The Price Cap Formula Adopted by the Commission Already Includes a Substantial Productivity Offset

The price cap mechanism adopted in the Rate Order already includes a productivity offset by limiting annual adjustments in rates to the increase in the Gross National Product Price Index (GNP-PI). As the Commission notes, "...[t]he GNP-PI automatically reflects certain productivity gains in the economy...." Notice at ¶ 83. Therefore, the price cap formula in the Rate Order guarantees that cable consumers will receive benefits in productivity improvement equaling or exceeding the benefits consumers receive, on average, in unregulated markets.

C. Historical Productivity Data for the Cable Industry are Unlikely to Provide a Reasonable Guide to Future Performance

The economic performance of the cable industry in terms of expansion of output, increases in market penetration and improvements in service quality has been quite good.¹⁹ This performance may translate to high observed levels of productivity change as cable companies have been able to take advantage of

¹⁸ As discussed below, the price cap formula requires cable operators to pass through productivity increases.

¹⁹ See Daniel Kelley, Economics of Cable Television Regulation, January 27, 1993 at pp. 3-4 (filed with the Comments of Time Warner).

both economies of fill and economies of scale.²⁰ However, the improvements in cable economic performance have been achieved only through investments in new technologies and expanded capacity.

The historical performance of the cable industry does not provide a reliable basis for predicting future productivity increases. Productivity increases that have been generated as a result of economies of fill and economies of scale cannot be expected to continue at the same level in the future. The major driver of future productivity increases will be technological change. Because, in many instances the basic broadband infrastructure necessary to enable the provision of basic and cable programming services is in place and is unlikely to be greatly affected by technological change, future productivity gains related to regulated services are likely to be modest, erratic, and unpredictable.

The final reason why historical experience cannot be used as a guide to future productivity performance is that the industry has been largely unregulated for the last several years. Regulation presents an entirely new environmental factor for the industry. Substantial reductions in productivity are the likely result. Costs will increase directly as the industry adds staff

²⁰ Economies of fill are caused by efficiencies due to more intensive utilization of a given plant size. Economies of scale represent efficiencies due to increasing plant size as output increases justify larger plants. Technological efficiencies represent reductions in average cost due to the deployment of new technologies.